APPENDIX TO NOTICE OF PUBLIC MEETING

California Department of Managed Health Care

PacifiCare of California's Notice of Material Modification Proposing an Indirect Change of Control that would result from a merger of PacifiCare Health Systems, Inc. into a UnitedHealth Group, Inc. subsidiary

August 25, 2005
10:30 A.M.

MEETING LOCATION
City of Santa Ana Council Chambers
20 Civic Center Plaza
Santa Ana, CA 92702

I. SUMMARY OF REGULATORY AUTHORITY OF THE DEPARTMENT OF MANAGED HEALTH CARE

Under the Knox-Keene Health Care Service Plan Act of 1975 (Knox-Keene Act), the Department of Managed Health Care (Department) has broad power to regulate health plans and to ensure that the interests of enrollees are protected. To administer and enforce the Knox-Keene Act, the Director's powers include, but are not limited to, the following:

- Assisting, advising and cooperating with federal, state and local agencies to protect and promote the interests of enrollees, providers, plans and the public;
- Holding public meetings, subpoenaing witnesses, taking testimony, compelling the production of books, papers, documents and other evidence; and,
- Determining that the investments of plan assets are sufficient to meet safeguards related to financial responsibility.

A plan obtains a Knox-Keene Act license by filing an application with the Department detailing its general business and ownership structure, key officers, contracts with health care providers, proposed method of providing health care services (including physical facilities to ensure access and quality of care), intended service areas and product lines and financial statements certified by a public accountant to ensure the maintenance of adequate reserves and the integrity of claims payments.   The Department reviews the application and determines whether the plan meets Knox-Keene guidelines. If the plan meets the requirements for licensure, the Department grants a license and retains jurisdiction to regulate the health care service plan.

With some exceptions, each time a plan modifies any information contained in its original application for licensure, it must disclose those changes in a formal filing with the Department. A "Notice of Material Modification," which requires the

Director's approval before implementation, is utilized when the plan proposes a substantive change in its business structure, delivery model or service area.

The Department reviews the proposed Material Modification to ensure that, post-transaction, the plan will remain in compliance with all licensure requirements. If a particular aspect of the Material Modification involves the application of a specific mandate of the Knox-Keene Act, the Department's review incorporates the specific criteria in that provision.

Any proposed change of control, merger or acquisition of a licensed health care service plan necessitates a Material Modification filing and requires the Department's approval before the transaction can close.

As part of the review process, Department staff identify issues that may potentially impact the delivery of health care services to California enrollees and develop written Undertakings that memorialize the major plan promises and representations offered as part of the Material Modification. These promises are an integral part of the Material Modification and are enforceable post-transaction.

II. SUMMARY OF KEY ISSUES

The Department received a Notice of Material Modification from PacifiCare of California ("Plan") on August 2, 2005 proposing a change in control of its parent company, PacifiCare Health Systems, Inc. (PHS) through a merger between PHS and a UnitedHealth Group, Inc. subsidiary. The Department has identified several initial issues for which public comment is requested.

1. Will the PacifiCare-United merger facilitate or impede the ability of PacifiCare to maintain appropriate administrative and organizational capacity as required by the Knox-Keene Act?

A plan must maintain the organizational and administrative capacity to timely provide basic health care services to enrollees. To ensure that the plan provides enrollees timely access to care, qualified medical providers must render medical decisions unhindered by fiscal and administrative management. To facilitate the Department's regulatory oversight and to ensure compliance with this mandate, the plan's books and records must be kept and maintained in California.

The Department has identified other critical functions of licensed plans that should remain in this state:

1) Medical Director, to monitor the appropriate scope of clinical services;
2) Clinical decision-making and clinical policy, including the determination of a plan's formularies;
3) Prior authorization and referral process;
4) Grievance process (including Independent Medical Review); and,
5) Administration of the Provider Dispute Resolution Mechanism.

PacifiCare of California is currently headquartered in Cypress, California and the Plan has represented that the headquarters will remain in the same location in the future.

2. Will the PacifiCare-United merger reduce or generate additional administrative expenses for PacifiCare of California in violation of the Knox-Keene Act?

A plan's operations, including administrative costs, must be fiscally sound. Administrative costs (which include salaries, bonuses, and benefits to officers, directors, or other principal management, legal and accounting expenses and fees, and all costs incurred in the operation of the plan which are not essential to the actual provision of health care services to enrollees) must be reasonable and necessary. If a plan's administrative costs exceed 15 percent for any reporting period, the plan is required to demonstrate that administrative costs are not excessive and are justified under the circumstances. In addition, the Department must approve any administrative service arrangements that could result in upstreaming excessive payments to the plan's parent.

The percentages of PacifiCare of California's administrative costs-to-premium revenues as reported in Quarterly Financial Reports filed with the Department for the years 2003 through 2005 were between 8.9 percent and 11.72 percent. In the most recently reported quarter, the percentage of administrative costs-to-premium revenues was 9.26 percent.

3. Will the PacifiCare-United merger facilitate or impede the ability of PacifiCare of California to remain compliant with the financial requirements of the Knox-Keene Act?

In addition to aspects discussed above, a fiscally sound operation requires a plan to maintain sufficient working capital, limit indebtedness, secure insurance, and maintain appropriate levels of Tangible Net Equity (TNE). The plan's long-term assets should not be substituted for liquid assets that are necessary to ensure the timely reimbursement of provider claims and liabilities arising from daily operations. Fiscal soundness must include provisions for contingencies, such as continuation of benefits to enrollees in the event of insolvency.

A plan is required to assume full financial risk for the provision of covered health care services. Guaranteeing or assuming the financial obligations of an affiliate or the declaring and distributing of dividends to an affiliate can impair the ability of a plan to meet its obligations. Accordingly, these activities must be restricted to ensure that the plan's fiscal soundness and required levels of TNE are not impaired.

Finally, the calculation of appropriate reserves for the payment of incurred but not reported (IBNR) provider claims must be appropriate. Adjusting the methodology for calculating IBNR reserves to free up cash for dividends, to meet minimum TNE requirements or to fund future acquisitions can negatively impact a plan's fiscal soundness.

4. Will the PacifiCare-United merger have a negative or positive impact on UnitedHealth Group's ability to remain financially viable and to not negatively impact California operations?

An entity acquiring a Knox-Keene licensed plan must be financially stable and committed to developing California operations. In its review process, the Department examines the strength of the purchaser's financial position, looking particularly at companies' net tangible assets and value of goodwill.

As part of the review process, the Department examines the cost of the transaction and the purchaser's ability to fund the transaction without jeopardizing the new subsidiary's financial stability. The purchaser must demonstrate that it will not assume more debt than it can reasonably service and must describe its intentions to pay any debt incurred to fund the transaction. The Department also examines a purchaser's explanation as to its ability and plans to pay debt gained by virtue of assuming the new subsidiary's debt. The Department is particularly concerned with the financial relationship between the parties post-transaction, examining whether the parent company will service acquired debt through dividends paid by the new subsidiary.

UnitedHealth Group exited the California full-service HMO market in 2000, claiming that it did not have the infrastructure to maintain its California operations. PacifiCare Health Systems, Inc.'s infrastructure is substantial and this purchase provides a platform for UnitedHealth Group to reenter the California market. This purchase also appears to be consistent with UnitedHealth Group's growth strategy over the past few years, which has included several acquisitions across the country.

According to recently reported public financial statements, UnitedHealth Group reported $42,000,000 in net tangible assets, and PacifiCare reported $682,000 in net tangible assets. UnitedHealth Group has stated that it will fund the $8.1 billion acquisition price with a combination of cash and stock.

5. Will the PacifiCare-United merger have a negative or positive impact on the Knox-Keene licensed PacifiCare Health System's and UnitedHealth Group, Inc.'s specialized plan affiliates?

The Department has jurisdiction over specialized plans including behavioral health, dental, and vision plans in California. Like full-service HMO plans, specialized plans are similarly subject to comprehensive regulatory standards relating to quality and accessibility of care. Both PacifiCare Health Systems, Inc. and UnitedHealth Group Inc. have specialized plan affiliates licensed in California. The companies represent that there will be no immediate integration of these plans.

PacifiCare has significant enrollment in its Knox-Keene licensed specialized plan affiliates, including PacifiCare Behavioral Health (PCBH) and PacifiCare Dental. PCBH has approximately 1.5 million enrollees in Group and Medicare Risk markets. PacifiCare Dental has approximately 326,000 enrollees in the Group, Medicare Risk, and Individual markets.

UnitedHealth Group currently has five specialized plan affiliates that are licensed by the Department. These plans include US Behavioral Health, Dental Benefit Providers of California, Inc., Pacific Union Dental, Inc., Spectera Vision Services Plan and ACN Group of California. Except for Spectera, which also offers individual products, these plans offer only group coverage. The total enrollment in these specialized plans is close to 3,000,000, with the highest enrollment in US Behavioral Health, at 2.4 million.

6. Will the PacifiCare-United merger have a negative or positive effect on the California health care market and consumers' ability to obtain both existing and new affordable health care products and programs?

A plan is required to provide its enrollees quality care and continuity of health care services. In this regard, fiscal and administrative management may not unduly influence medical decisions. Prior to introducing a new health benefit plan product, withdrawing a product, or ceasing to arrange for the provision of health care for enrollees, a plan must notify the Department and provide adequate notice to enrollees and providers. The Department periodically conducts onsite medical surveys of each plan to ensure its compliance with these and several other quality-of-care oversight requirements.

Currently PacifiCare of California has a variety of commercial products and serves a significant Medicare population in the state. In the first quarter of 2005, PacifiCare reported a total of 1,673,713 enrollees in California. Most of PacifiCare's enrollment is in the large group commercial market, with 1,030,237 enrollees (about 62% of total PacifiCare of California enrollment). The Medicare Risk population is made up of approximately 360,000 enrollees. Small group enrollment in PacifiCare plans is approximately 150,000, and point-of-service enrollment is approximately 100,000. About 24,000 enrollees purchase PacifiCare's Individual coverage.

United is a national health care company with insurance companies and HMOs in states across the country. As discussed above, both PacifiCare and United also have specialized plan affiliates.

Over the past several years, health plan consolidation has been prevalent in California and across the country. This consolidation may have an impact of consumers' ability to gain access to affordable health plan products. The availability and affordability of these plans could similarly be enhanced or threatened by the further market consolidation caused by this merger.